



2013

Social Enterprise: Who Needs It?

Brian Galle

Georgetown University Law Center, brian.galle@law.georgetown.edu

This paper can be downloaded free of charge from:
<https://scholarship.law.georgetown.edu/facpub/1843>
<https://ssrn.com/abstract=2302658>

54 B.C. L. Rev. 2025 (2013)

This open-access article is brought to you by the Georgetown Law Library. Posted with permission of the author.
Follow this and additional works at: <https://scholarship.law.georgetown.edu/facpub>



Part of the [Business Organizations Law Commons](#), and the [Tax Law Commons](#)

HEINONLINE

Citation: 54 B.C. L. Rev. 2025 2013

Provided by:

Georgetown Law Library



Content downloaded/printed from [HeinOnline](#)

Mon Nov 28 13:33:15 2016

- Your use of this HeinOnline PDF indicates your acceptance of HeinOnline's Terms and Conditions of the license agreement available at <http://heinonline.org/HOL/License>
- The search text of this PDF is generated from uncorrected OCR text.
- To obtain permission to use this article beyond the scope of your HeinOnline license, please use:

[Copyright Information](#)

SOCIAL ENTERPRISE: WHO NEEDS IT?

BRIAN GALLE*

Abstract: State statutes authorizing firms to pursue mixtures of profitable and socially beneficial goals have proliferated in the past five years. In this invited response essay, I argue that for one large class of charitable goals, the so-called “social enterprise” firm is often privately wasteful. Although the hybrid form is a bit more sensible for firms that combine profit with simple, easily monitored social benefits, existing laws fail to protect stakeholders against opportunistic conversion of the firm to pure profit-seeking. Given these failings, I suggest that social enterprise’s legislative popularity can best be traced to a race to the bottom among states competing to siphon away federal tax dollars for local businesses. Not all hybrid forms inevitably are failures, however. For example, the convertible debt instruments proposed by Dana Brakman Reiser and Steven Dean—the inspiration for this response—offer a promising route forward for “cold glow” firms wishing to clean up some easily-measured but harmful business practices.

INTRODUCTION

Social enterprise lawmaking is a growth industry. Over the past four years, state statutes authorizing new forms of corporate entities have proliferated.¹ The new entities come in several flavors—low-profit limited liability companies, “benefit corporations,” and others—all with the common element that they purport to authorize the firm’s managers to mix profit with some other socially valuable function.

These developments are puzzling. As I argue here, organizational theory suggests that these “hybrid” forms will typically be dominated either by traditional nonprofit forms, or instead by plain old for-profits. The large transaction costs of mixing complex charitable goals with

© 2013, Brian Galle. All rights reserved.

* Associate Professor, Boston College Law School. I’m grateful for helpful comments from Kelli Alces, Mark Blumberg, Evelyn Brody, Jack Horak, Ben Leff, Peter Molk, and Mark Underberg. My special thanks to Dana Brakman Reiser and Steven Dean for the opportunity to comment on their piece, and for their gracious responses.

¹ Stephanie Strom, *A Quest for Hybrid Companies That Profit, But Can Tap Charity*, N.Y. TIMES, Oct. 12, 2011, at B1; Rachel Culley & Jill R. Horwitz, *Profits v. Purpose: Hybrid Companies and the Charitable Dollar* 4–5 (Univ. of Mich. Pub. Law. & Legal Theory Working Paper Series, Working Paper No. 272, 2012), available at <http://ssrn.com/abstract=2055368>.

profit imply that only considerable economies of scope, or perhaps a handful of other unusual combinations of circumstances, can justify the combination.

Of course, not all socially beneficial goals are complex. Firms with simple aims, such as paying living wages or avoiding particular toxic inputs, can more easily contract with their stakeholders or commit to their customers. For these firms, the problem is that one or more owners may decide to sell to someone uninterested in the original do-gooder bargain. Existing social enterprise statutes only superficially address that problem.

Against this backdrop, Dana Brakman Reiser and Steven Dean have arrived to propose an alternative.² Rather than a new form of firm, they suggest that, with a few tweaks to standard debt covenants, entrepreneurs can successfully raise money both to earn profits and do some good. Notably, as they acknowledge, their proposal aims only to protect investors and entrepreneurs from opportunistic sales by their counterparty, and does not do much to bind either side during the ordinary course of the firm's dealings. Their proposal does, however, fill exactly the hole social enterprise currently faces.

Their proposal therefore reinforces my general claim that existing social enterprise statutes add little if any social value.³ In the meantime, proponents are busily attempting to secure various forms of subsidy. Unless the existing statutes evolve, lawmakers and regulators should view these calls for subsidy with deep suspicion.

Part I of this Essay sets out background economic theory on the formation of nonprofits, and adds a new tidbit on the distortionary effects of tax rules on the choice of entities.⁴ Part II expands on the transaction-costs critique of hybrid entities, arguing that the case for using these forms to produce most standard charitable goods is implausible.⁵ Part III elaborates on the suggestion that social enterprise may overcome some narrow problems in for-profit firms that want to elimi-

² Dana Brakman Reiser & Steven A. Dean, *Hunting Stag with FLY Paper: A Hybrid Financial Instrument for Social Enterprise*, 54 B.C. L. REV. 1495, 1544 (2013).

³ I am not the only skeptic. See, e.g., Daniel S. Kleinberger, *A Myth Deconstructed: The "Emperor's New Clothes" on the Low-Profit Limited Liability Company*, 35 DEL. J. CORP. L. 879, 881 (2010) (criticizing the low-profit limited liability company form); see also J. William Callison & Allan W. Vestal, *The L3C Illusion: Why Low-Profit Limited Liability Companies Will Not Stimulate Socially Optimal Private Foundation Investment in Entrepreneurial Ventures*, 35 VT. L. REV. 273, 274 (2010) (criticizing the low-profit limited liability company form but generally supporting the notion of social enterprise).

⁴ See *infra* notes 9–23 and accompanying text.

⁵ See *infra* notes 24–59 and accompanying text.

nate some “cold glow” aspects of their production process.⁶ Part IV considers whether the growing legislative popularity of social enterprise casts doubt on my claim that it is mostly superfluous; I argue that it does not, because existing hybrid entities are spawned instead by a race to the bottom.⁷ Part V returns to the Brakman Reiser and Dean proposal, showing how, despite its limits, the proposal does help social enterprise to overcome the main problem it currently faces.⁸

I. THE CONTRACT-FAILURE THEORY OF THE NONPROFIT FIRM

To understand why many existing hybrid entity proposals are deeply flawed, it is helpful first to understand the problem that social enterprise purports to solve. Why would anyone ever want to found a social enterprise, or to invest in one? Profits, of course, are nice. So is saving the world. But what would make someone want to do both in one organization?

Let’s begin with a step backward to “pure” or traditional nonprofits. By definition, a nonprofit is a firm that can’t distribute net profits to the people who control or invest in it.⁹ Why, then, would an entrepreneur with an exciting new idea form one? The short answer, first developed by Henry Hansmann and later elaborated by other economists, is transaction costs and asymmetric information.¹⁰ Suppose the new idea is a low-cost method for improving the lives of sub-Saharan farmers. Our irrigation entrepreneur—let’s call her Ellie—plans to sell her services not to the farmers who will most directly benefit, but instead to others, who want to see the farmers achieve a better life. Perhaps these funders are generous souls; maybe they are just oil companies who want to see greater political stability in resource-rich areas. Either way, once she has accepted money from her “customers,” Ellie can easily appropriate most of the firm’s resources to her own goals. For instance, she can disappear into the desert with the dollars. Or, more realistically, she might deliver a very low-quality product that allows her greater net profits.

⁶ See *infra* notes 60–79 and accompanying text.

⁷ See *infra* notes 80–90 and accompanying text.

⁸ See *infra* notes 91–99 and accompanying text.

⁹ Henry B. Hansmann, *The Role of Nonprofit Enterprise*, 89 YALE L.J. 835, 838 (1980).

¹⁰ David Easley & Maureen O’Hara, *The Economic Role of the Nonprofit Firm*, BELL J. ECON., Autumn 1983, at 531, 536; Edward L. Glaeser & Andrei Shleifer, *Not-For-Profit Entrepreneurs*, 81 J. PUB. ECON. 99, 100–01 (2001); Hansmann, *supra* note 9, at 843–45; George G. Triantis, *Organizations as Internal Capital Markets: The Legal Boundaries of Firms, Collateral, and Trusts in Commercial and Charitable Enterprises*, 117 HARV. L. REV. 1102, 1147 (2004).

Contract law, or other less formal arrangements, comprises one standard set of solutions to this kind of dilemma.¹¹ When payment and performance are not simultaneous, the second-moving party has opportunities for hold-ups and self-dealing. But the threat of liability for breach, or some similar but less formal sanction, constrains these behaviors, and thus creates incentives for both sides to invest in their mutually beneficial deal.

What makes Ellie's firm distinctive is that it is difficult to draft *ex ante* an enforceable contract to constrain her potential for opportunism. In Hansmann's version of the story, the problem is typically that the "customers," those who are paying Ellie for her work, do not directly observe the quality of her outputs, or do not observe whether their individual contribution is used to further that quality.¹² Further, it is difficult to imagine how one could write a contract that would specify the quality of the firm outputs in a way that could be enforced by a court.¹³ One could measure intermediate results, such as the farmers' crop yields, but determining quality of life is more challenging. Or perhaps the contract could be written, but the costs of specifying all the tradeoffs and exceptions each side could invoke would be prohibitive, relative to the value of the venture. For instance, should Ellie be liable if she claims she exerted a lot of effort, but there happened to be a bad drought that year? Negotiating that provision will take a long time.

Hansmann's argument, later supported formally in models by Edward Glaeser and Andrei Shleifer, is that the nonprofit form is a partial solution to these kinds of contract failures.¹⁴ By promising to limit her payouts, Ellie has lowered her own incentives for later misappropriations. To be sure, those incentives have not disappeared; she might still simply take the money and run. But she has less of an incentive to cut quality to increase her returns.¹⁵

¹¹ See generally Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305 (1976) (explaining how contracting relates to firm formation).

¹² Hansmann, *supra* note 9, at 846–48, 850–51.

¹³ See Geoffrey A. Manne, *Agency Costs and the Oversight of Charitable Organizations*, 1999 WIS. L. REV. 227, 228–29; Triantis, *supra* note 10, at 1147–49.

¹⁴ Glaeser & Shleifer, *supra* note 10, at 103–06; Hansmann, *supra* note 9, at 844; cf. Kenneth J. Arrow, *Uncertainty and the Welfare Economics of Medical Care*, 53 AM. ECON. REV. 941, 965 (1963) (suggesting that the profit-making aspect of hospitals is relatively unimportant because the doctors' commitment to professionalism assures patients that doctors will prioritize their care over profits).

¹⁵ Hansmann suggests that the nonprofit promise could be enforced through private contracts, including contracts to limit distributed profit to a fixed amount or a portion of gross revenues. Hansmann, *supra* note 9, at 851–52. He argues that the nonprofit form is

In return, Ellie can claim a basic salary and other perquisites. For example, she gets to use the firm's resources to further her personal goals. Of course, the combination of small cash and big personal rewards will be most appealing to entrepreneurs who are strongly motivated by those personal goals.¹⁶ Alternately, as I have argued elsewhere, the entrepreneur's rewards may come from being *perceived* as virtuous by others.¹⁷ Then her commitment to sacrifice profits not only reassures her funders, but also boosts her personal reward by increasing public perceptions of her generosity.

Prior accounts have glossed over the importance of tax to the choice of nonprofit form—not the firm's tax, but the entrepreneur's. Profits are taxable, but personal satisfaction and the “warm glow” of being perceived as virtuous are not.¹⁸ Under the U.S. income tax, this difference in effect provides up to a nearly 40% subsidy to entrepreneurs who trade cash profits for psychic rewards.¹⁹ Ellie and her investors can divide this subsidy between themselves. Further, to the extent that the investors, too, get personal satisfaction from investing with El-

generally preferable because it economizes on drafting and enforcement costs. *Id.* This is puzzling, as permitting some limited distribution of profit seems inconsistent with the rest of his account. Capping profit payouts does cabin the managers' incentives to cut quality. But how can individual contributors know whether their money makes any marginal contribution to charitable production? *Cf.* Glaeser & Shleifer, *supra* note 10, at 109 (observing that donors do not contribute to for-profit firms because contributions are unlikely to increase quality on the margins). For example, imagine that a manager works for profit until she hits the cap, and then for charity for the rest of the year. Contributors cannot know whether their funds will be used in the first stage or the second, or indeed if there will be a second stage, because the manager's incentive is to just barely reach it. This is akin to the public goods problem Hansmann previously identifies as a source of contract failure. Hansmann, *supra* note 9, at 850–51.

¹⁶ Myron J. Roomkin & Burton A. Weisbrod, *Managerial Compensation and Incentives in For-Profit and Nonprofit Hospitals*, 15 J.L. ECON. & ORG. 750, 753–54 (1999) (discussing compensation mechanisms and the utility of nonmonetary incentives).

¹⁷ Brian Galle, *Keep Charity Charitable*, 88 TEX. L. REV. 1213, 1224–25 (2010).

¹⁸ See Daniel Shavito, *The Man Who Lost Too Much: Zarin v. Commissioner and the Measurement of Taxable Consumption*, 45 TAX L. REV. 215, 223–29 (1990) (discussing the standard income tax approach to non-material benefits).

¹⁹ *Id.* at 223–24. The real subsidy is probably a good bit smaller. First, many managers are likely to be taxed at below the maximum statutory rate. See I.R.C. § 1(a) (2006) (providing for a graduated rate of tax on individual taxable income). Second, small businesses are already heavily subsidized, such as through devices that allow entrepreneurs lawfully to convert their heavily taxed labor income into lightly taxed capital earnings. Victor Fleischer, *Taxing Founders' Stock*, 59 UCLA L. REV. 60, 80–88 (2011). Moreover, even if Ellie's business were taxable, some or all of this subsidy could be lost at the firm level because the firm would likely lose the deduction it would otherwise have claimed if it had paid Ellie in cash. See *id.* Finally, many small businesses unlawfully reduce their tax bill by underreporting income. See Joel Slemrod, *Cheating Ourselves: The Economics of Tax Evasion*, J. ECON. PERSP., Winter 2007, at 25, 29–30.

lie, and take a lower payout as a result, they are also receiving a tax subsidy—they swap taxable profits for untaxed satisfaction.

To be sure, the nonprofit form is costly. For one, you can't eat prestige: satisfaction and other perquisites of entrepreneurship are less liquid than cash compensation would be. Exiting a venture is also difficult for the entrepreneur; ownership stakes in the firm cannot readily be sold, so founders who walk away from their venture typically must sacrifice any property or "sweat equity" they've contributed to the firm.²⁰ Further, because the firm cannot sell equity to raise money, its main non-donative source of outside funding will be through borrowing. Debt financing adds additional "agency costs" to the firm: Since the creditors' interest does not align with the managers', the firm must negotiate and submit to costly bonding provisions that may limit its flexibility.²¹

Firms choose nonprofit status, then, when the benefits exceed these costs.²² Entrepreneurs who derive large value from perquisites—those who are strongly motivated by altruism or warm glow—are more likely to accept the tradeoff of perks over cash tradeoff. That tradeoff is also easier to swallow when there wouldn't be much profit to distribute anyway.²³ Nonprofit status is also more attractive when the costs of giving up equity financing are lower, that is, when equity financing would be prohibitively expensive, debt is cheap, or the firm has access to some special funding such as donations or government grants. Presumably

²⁰ Exit constraints are a bit looser under many state laws. States typically permit nonprofits to opt to be "mutual benefit" corporations, in which case the firm can repurchase ownership stakes from its members. MARION R. FREMONT-SMITH, GOVERNING NONPROFIT ORGANIZATIONS 159–60 (2004). But these entities are generally not eligible for federal 501(c)(3) status, and they typically cannot claim most state-level tax benefits reserved for "community benefit" or charitable organizations. See Treas. Reg. § 1.501(c)(3)-1(b) (as amended in 2008) (requiring applicants to demonstrate that firm assets will be reserved for charitable purposes upon dissolution).

²¹ The agency costs of debt may be somewhat lower at nonprofit firms than at traditional for-profit firms. Usually, an entrepreneur and her equity investors take more risks than lenders would prefer because the equity holders are entitled to all the upside gains that would result from successful gambles. Jensen & Meckling, *supra* note 11, at 334–35. By definition, nonprofit managers do not have this opportunity. Instead, they draw a salary, which makes them in effect a creditor of the firm. So it would seem that this traditional source of creditor-manager conflict does not arise. There could, however, be other sources of conflict. Other stakeholders, such as donors, may offer the manager some incentives, such as bonuses, to take on additional risk. Creditors may also demand that the firm be managed in a way that preserves existing revenue streams, even if that revenue is no longer an important goal for the firm. Consider, for instance, a hospital with significant debts that is reviewing its charity-care and debtor-forgiveness policies. Creditors may demand a more revenue-friendly approach than the hospital's managers want to pursue.

²² Hansmann, *supra* note 9, at 879.

²³ Glaeser & Shleifer, *supra* note 10, at 105.

the tax subsidy for perks also tips some marginal entrepreneurs from for-profit to nonprofit.

II. SOCIAL ENTERPRISE AND THE THEORY OF THE (HYBRID) FIRM

This account of the nonprofit firm makes social enterprise, or what I've been calling "hybrid" firms, something of a puzzle.²⁴ An otherwise profit-making firm that wants also to produce some charitable good seems to face all of the costs I've just mentioned. In many instances, those costs are even greater than they would be for a pure charity, and the offsetting benefits are even smaller.

A. *Make or Buy?: The Downside of Integration*

Most obviously, the opportunity costs of charitable spending are higher at a profitable firm. In general, if the firm is allocating capital efficiently, it should have new investment opportunities that exceed those available in the general marketplace for capital.²⁵ If the firm can't do better than its shareholders with its money, the shareholders will demand that the firm return the cash to them so they can invest with it. Giving up these supranormal returns in order to invest in creating some charitable output is thus costlier than if the shareholders spent the money themselves. The firm's stakeholders will have to place a particularly high value on perks to justify this higher expense.

Consider next the costs of contracting. There is nothing about running a for-profit business that makes the difficulty of contracting for the production of charitable goods easier, and indeed the opposite is very likely true. Suppose the entrepreneur and her investors jointly agree that they want to divert some of the firm's revenues to the charitable activity.²⁶ But how much charity will the firm do, at what quality, and at what cost? Now the investors have two worries: that the manager will do too little charity, and also that she will do too much.²⁷

²⁴ Although the term "social enterprise" can also include organizational forms other than the "hybrid form" I have discussed, see Robert A. Katz & Anthony Page, *The Role of Social Enterprise*, 35 VT. L. REV. 59, 60–62 (2010), I use the two terms as synonyms here for convenience.

²⁵ WILLIAM J. CARNEY, *CORPORATE FINANCE: PRINCIPLES AND PRACTICE* 717 (2d ed. 2010).

²⁶ Assume for now that the charitable output cannot itself be produced at a profit. For example, it might be a quasi-public good: when one person buys it, many other people can also benefit without paying. Then almost no one has an incentive to pay.

²⁷ Cf. Briana Cummings, Note, *Benefit Corporations: How to Enforce a Mandate to Promote the Public Interest*, 112 COLUM. L. REV. 578, 602–13 (2012) (arguing that existing outside

Worse, the investors will have lost what used to be one of their most effective monitoring tools. When the firm was purely profit-seeking, it was easy for investors to pay the manager in a way that would align her interests with theirs: they gave her stock, or stock options, making her a partial owner like them.²⁸ There is currently no pay instrument, however, that matches a manager's ex ante expected pay to her performance in fulfilling charitable goals—no surprise, given that those goals are tough to measure.²⁹ So now the manager has two tasks, only one of which can easily be encouraged through incentive pay. In that setting, some economists argue, agency costs are so high that it is often preferable to simply split the two sets of tasks into two distinct firms.³⁰

For similar reasons, the hybrid firm likely cannot obtain cheap financing through donations. Donors, like other investors, have no real way to control the hybrid manager. And donors are even worse off than many investors because they have no “exit” option. Investors unhappy with what they are able to observe of the entrepreneur's behavior can usually just sell, if the firm's shares are reasonably liquid, and buy stock in another company more suited to their preferences.³¹ Donors, in contrast, usually can't get their money back. Perhaps the donor can write a contract that authorizes reimbursement if the donee misuses the funds,

monitoring tools for hybrid entities are a poor fit for goals such as “diversity,” “health,” or “education”). For additional discussion of the two-task problem in the production of public goods, see AVINASH K. DIXIT, *THE MAKING OF ECONOMIC POLICY: A TRANSACTION-COST POLITICS PERSPECTIVE* 95–98 (1996); Daron Acemoglu et al., *Incentives in Markets, Firms, and Governments*, 24 J.L. ECON. & ORG. 273, 274 (2007); Oliver Hart et al., *The Proper Scope of Government: Theory and an Application to Prisons*, 112 Q.J. ECON. 1127, 1136–41 (1997). Even if the parties could negotiate a contract in advance in an effort to balance the competing goals, doing so would sacrifice some of the entrepreneur's superior knowledge and capacity for experiment. Benjamin Moses Leff, *The Case Against For-Profit Charity*, 42 SETON HALL L. REV. 819, 851–52 (2012).

²⁸ See David I. Walker, *The Law and Economics of Executive Compensation: Theory and Evidence*, in RESEARCH HANDBOOK ON THE ECONOMICS OF CORPORATE LAW 232, 236–37 (Claire A. Hill & Brett H. McDonnell eds., 2012). It is usually argued that options are needed to make managers fully as risk-seeking as investors. *Id.* at 237–38. The manager, unlike the fully diversified investor, has undiversifiable human capital invested in the firm; therefore, she must be given an instrument that offers her pure upside to compensate her for taking risky wagers with her human capital. *See id.*

²⁹ See Jill R. Horwitz, *Why We Need the Independent Sector: The Behavior, Law, and Ethics of Not-for-Profit Hospitals*, 50 UCIA L. REV. 1345, 1410–11 (2003) (arguing that incentive-based pay is inaccurate and therefore undesirable in charitable organizations).

³⁰ Bengt Holmstrom & Paul Milgrom, *Multitask Principal-Agent Analyses: Incentive Contracts, Asset Ownership, and Job Design*, 7 J.L. ECON. & ORG. 24, 43–48 (1991); Bengt Holmstrom, *The Firm as a Subeconomy*, 15 J.L. ECON. & ORG. 74, 90–99 (1999).

³¹ D. Gordon Smith, *The Role of Shareholders in the Modern American Corporation*, in RESEARCH HANDBOOK ON THE ECONOMICS OF CORPORATE LAW, *supra* note 28, at 52, 61–62.

maybe even with interest.³² But, again, those contracts are extremely difficult to write and enforce, as any casual student of the law of charitable trusts could attest.³³ And donors of labor—volunteers—almost certainly cannot reclaim their lost investment.

In addition to these higher costs, the rewards of charitable work at a hybrid may be lower, too. I've argued before that even if investors can monitor the entrepreneur, outside observers usually can't.³⁴ If the good graces of those observers is an important source of warm glow for managers and investors, then the hybrid form costs both groups a good deal of reward—reward that is specially tax-favored relative to cash.³⁵

Given all these factors, it seems the best option for the firm and its investors will often be to “buy” charity, rather than “make” it.³⁶ That is, even if it makes sense to use firm funds for charitable work (or for investors to allow the firm to buy charitable output on their behalf), there is no reason the work has to be done inside the firm. The firm could instead just find an outside charity—or, heck, found one—and donate money to it.³⁷

Allocating charitable production to an outside firm also makes sense from a managerial perspective. The time and attention of top leadership is a key, and scarce, resource for the firm.³⁸ Managers skilled at profitably operating in their own industry may lack skill or interest in supervising an in-house charity.

³² State law traditionally was hostile to revocable gifts, but the modern trend is toward increased donor control. FREMONT-SMITH, *supra* note 20, at 338–39.

³³ For an overview of the problems of enforcing gifts to charitable organizations over time, see *id.* at 173–84.

³⁴ Galle, *supra* note 17, at 1224–25.

³⁵ Admittedly, though, the tax benefits of perquisites are smaller for the hybrid firm. When the hybrid firm uses cash to replace lost warm glow, it can take a deduction against any taxable profit it earns. If the firm's marginal tax rate is equal to the employee's rate, the two effects are a wash. Currently, top individual rates are a bit higher than corporate rates, and are much higher than the effective tax rate for international firms. See Philip Dittmer, Tax Found., *U.S. Corporations Suffer High Effective Tax Rates by International Standards*, SPECIAL REP., Sept. 2011, at 1, 10, available at <http://taxfoundation.org/sites/taxfoundation.org/files/docs/sr195.pdf>. Compare I.R.C. § 1(a) (2006) (stating that the top individual tax rate is 39.6%), with I.R.C. § 11(b)(1)(D) (2006) (stating that the top corporate tax rate is 35%). In these latter two scenarios, there is still a net tax cost to replacing warm glow with cash.

³⁶ For an overview of the literature on the boundaries of the firm, and an empirical assessment, see Peter G. Klein, *The Make-or-Buy Decision: Lessons from Empirical Studies*, in HANDBOOK OF NEW INSTITUTIONAL ECONOMICS 435, 455–57 (Claude Ménard & Mary M. Shirley eds., 2008).

³⁷ Culley & Horwitz, *supra* note 1, at 16.

³⁸ Stephen M. Bainbridge, *Why a Board? Group Decisionmaking in Corporate Governance*, 55 VAND. L. REV. 1, 6–7 (2002) (discussing strategies for abating corporate shirking).

The collapse of Google.org (“DotOrg”), Google’s erstwhile philanthropic arm, is instructive in this regard. According to published accounts, Sergey Brin³⁹ was so bored during important DotOrg meetings that he would do pushups.⁴⁰ Experts opined that another of DotOrg’s main failings was that it treated every problem as an engineering problem instead of trying to understand what was really going wrong in the world.⁴¹ For instance, Google did not pursue solutions that its staff found too simplistic to challenge their programming skills.⁴² But it’s no surprise that was what DotOrg did, because, after all, it was run by engineers.

Lastly, donating to charity, rather than doing it, is also often federally tax-favored, as Lloyd Mayer and Joseph Ganahl have recently shown.⁴³ Firms can take an annual tax deduction for charitable contributions of up to 10% of their profits.⁴⁴ They receive that deduction in the year of the donation, regardless of when the charity actually spends the money.⁴⁵ In contrast, if the firm spent the same amount building its capacity to do good works, those costs would have to be capitalized. The firm would get only a fraction of the deduction immediately and would recover the rest over time as its capacity depreciates.⁴⁶ So donations are typically more valuable, taking into account the time-value of money.⁴⁷

B. *Reasons to Be Hybrid?*

Against this litany of problems with hybrid charity, we might stack the possibility of economies of scope or other efficiencies that could

³⁹ Aside for readers who may have just awakened from a twenty-year sleep: Brin is one of Google’s two founding genius programmers. *Management Team*, GOOGLE INC., <http://www.google.com/about/company/facts/management/> (last visited Oct. 17, 2013).

⁴⁰ Stephanie Strom & Miguel Helft, *Google Finds It Hard to Reinvent Philanthropy*, N.Y. TIMES, Jan. 29, 2011, <http://www.nytimes.com/2011/01/30/business/30charity.html>.

⁴¹ *Id.*

⁴² *Id.*

⁴³ Lloyd Hitoshi Mayer & Joseph R. Ganahl, *Taxing Social Enterprise*, 66 STAN. L. REV. (forthcoming 2014) (manuscript at 20–21), available at <http://ssrn.com/abstract=2256539>.

⁴⁴ I.R.C. § 170(b)(2)(a) (2006).

⁴⁵ BORIS I. BITTKER ET AL., FEDERAL INCOME TAXATION OF INDIVIDUALS ¶ 25.01[3] (3d ed. 2002).

⁴⁶ See, e.g., I.R.C. §§ 167, 199, 263, 263A.

⁴⁷ An exception would be if the firm were unprofitable on paper at the time of the donations—for example, because it already had lots of other carried-over deductions from past years available. In that case, the unused donations would carry forward into the future, likely making them comparable in value to the depreciation deductions the firm would get for producing in-house.

result from for-profit production of charitable goods.⁴⁸ One possible candidate could be intellectual property, held by a for-profit firm, that is also very valuable in producing a charitable good. Google's ability to use its search algorithms to track flu outbreaks is a potential example. In many cases the IP cannot simply be donated or licensed—for instance, because exploiting it requires deep technical sophistication, or sharing it risks undermining trade secrets or otherwise reducing the value of the IP to the owner firm. On the other hand, it's hard to imagine a firm with more valuable IP than Google, and even that wasn't enough to hold Google and Google.org together.

Another possible advantage often pointed to by supporters of the hybrid form is the superior cost effectiveness of for-profits.⁴⁹ The claim is that nonprofit managers have little incentive to find cost savings, so that a for-profit firm that takes on charitable goals can learn to do more with less.⁵⁰ I and other commentators point to some motives nonprofit managers might have to be efficient, such as the fact that satisfaction with accomplishing their mission substitutes for a share of the profits, that donors care about efficiency, or the possibility that boards might offer managers some limited forms of incentive pay.⁵¹ In the end, empirical investigation will have to determine which side is right. There is some evidence that donors indeed care at least about administrative costs, and that pay-for-performance does exist in the nonprofit sector, but the ultimate question remains open.⁵²

Hybrid advocates also mention that pure charities cannot easily access capital to scale up their production.⁵³ This is another version of the costs of capital point: if investors are happy to finance operations despite the risks of opportunism by the entrepreneur, of course it

⁴⁸ M. Todd Henderson & Anup Malani, *Corporate Philanthropy and the Market for Altruism*, 109 COLUM. L. REV. 571, 590–93 (2009). “Economies of scope” are savings that result when multiple products or tasks are delivered more efficiently as a bundle than they would if completed in separate firms.

⁴⁹ Katz & Page, *supra* note 24, at 92–93; Anup Malani & Eric A. Posner, *The Case for For-Profit Charities*, 93 VA. L. REV. 2017, 2048–50 (2007).

⁵⁰ Malani & Posner, *supra* note 49, at 2048–50.

⁵¹ Galle, *supra* note 17, at 1222–30; James R. Hines, Jr. et al., *The Attack on Nonprofit Status: A Charitable Assessment*, 108 MICH. L. REV. 1179, 1192–1203 (2010); Leff, *supra* note 27, at 868–75; Susan Rose-Ackerman, *Altruism, Nonprofits, and Economic Theory*, 34 J. ECON. LIT. 701, 719 (1996).

⁵² MARC JEGERS, *MANAGERIAL ECONOMICS OF NON-PROFIT ORGANIZATIONS* 50–51 (2008); *see also* Brian Galle & David I. Walker, *Nonprofit Executive Pay as an Agency Problem: Evidence from U.S. Colleges and Universities* 20–21 (Aug. 1, 2013) (unpublished manuscript), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2187979.

⁵³ Katz & Page, *supra* note 24, at 94.

makes less sense to take on the costs of the nonprofit form. It is unclear, though, whether expansion is or should be an important nonprofit goal. The agency problems of charitable production are likely only to get larger as the firm expands and each individual investor's control over the managers becomes more remote.

In any event, even charities with ready access to cash, such as universities, typically prioritize quality over quantity. The New York Philharmonic is not opening NYP-branded orchestras around the country, exactly because the point of the endeavor is grand artistic achievement, not pop music.⁵⁴

A final volley supporters of hybrid charities might offer would be to question whether the costs of contracting for charitable goods are really that high. Since Hansmann first wrote in the early 1980s, scholars have penned considerable new literature on the exchange of "credence" goods, or goods whose quality customers cannot easily monitor, ranging from legal services to organic foods.⁵⁵ Though these goods share the property that their producers have opportunities to cheat on quality, few of the firms producing them are organized as nonprofits.

Law firms likely offer the most familiar example for readers of this law review. Clients generally cannot closely observe the effort or quality of legal services. Despite law firms' lack of transparency, experts report that the firms stay in business through their reputations, trust-building human interactions, and professional standards with state-subsidized enforcement mechanisms, among other tools.⁵⁶

Other industries rely on different "technologies" for reducing agency costs.⁵⁷ Glaeser and Shleifer point to Silicon Valley, where co-location of many employers offers workers assurances that employers cannot easily exploit the workers' investment in industry-specific hu-

⁵⁴ See Glaeser & Shleifer, *supra* note 10, at 108 (arguing that nonprofits prioritize quality over quantity).

⁵⁵ E.g., Uwe Dulleck & Rudolf Kerschbamer, *On Doctors, Mechanics, and Computer Specialists: The Economics of Credence Goods*, 44 J. ECON. LIT. 5, 9–11 (2006); Curtis R. Taylor, *The Economics of Breakdowns, Checkups, and Cures*, 103 J. POL. ECON. 53, 65–69 (1995); Kenneth H. Wathne & Jan B. Heide, *Opportunism in Interfirm Relationships: Forms, Outcomes, and Solutions*, J. MARKETING, Oct. 2000, at 36, 45–50.

⁵⁶ Larry E. Ribstein, *Ethical Rules, Agency Costs, and Law Firm Structure*, 84 VA. L. REV. 1707, 1712–19 (1998); cf. OLIVER E. WILLIAMSON, *THE MECHANISMS OF GOVERNANCE* 116 (1996) (discussing the role of reputation in reducing opportunism in repeated contracting).

⁵⁷ Gary Gereffi et al., *The Governance of Global Value Chains*, 12 REV. INT'L POL. ECON. 78, 82–84 (2005); Taylor, *supra* note 55, at 65–69. In some cases the solution for reducing agency costs is regulation, such as malpractice liability. Dulleck & Kerschbamer, *supra* note 55, at 19–20.

man capital.⁵⁸ And, as they note, for some goods the cost of opportunism is relatively trivial—for how many people does it really matter how the farmer grew her tomato?—so that expensive commitment devices such as the nonprofit form are not worthwhile.⁵⁹

None of these examples make a clear case for hybrid entities. In each, it isn't so much that the firm has figured out how to contract to produce credence goods, as that some outside factor diminishes the need for any contract. We may nonetheless have walked just up to the edge of a viable model for the hybrid form: innovations in governance techniques that might allow firms credibly to commit to something other than pure profit.

III. TOWARD A THEORY OF THE HYBRID FIRM: WARMING UP COLD GLOW?

An example of governance innovations that might justify the hybrid form is what I'll call the thawing of the cold glow firm. The cold glow firm has a production process that stakeholders or consumers find particularly loathsome. It kills dolphins, poisons the water, sells "conflict diamonds," or hires factory workers at pennies per hour. For its sins, it must sell products at a discount, pay out higher rates of return to investors, pay managers a premium, or all of the above.⁶⁰

Firms have learned how to contract around many of these problems. As ample literature now demonstrates, firms can hire outside auditors or other third-party verification systems to oversee the firm's compliance with cold glow reducing goals.⁶¹ If the goals are readily defined, quantified, and measured, then both contract drafting and enforcement can be fairly cheap. For instance, if the firm pledges to pay workers at least median hourly wages for their home country, or to "off-

⁵⁸ Glaeser & Shleifer, *supra* note 10, at 108.

⁵⁹ *Id.*

⁶⁰ Cf. Michael C. Jensen, *Value Maximization, Stakeholder Theory, and the Corporate Objective Function*, J. APPLIED CORP. FIN., Fall 2001, at 8, 16–17 (arguing that firm value may depend on the attitudes and emotions of customers and stakeholders towards the firm); Michael E. Porter & Claas van der Linde, *Toward a New Conception of the Environment-Competitiveness Relationship*, J. ECON. PERSP., Fall 1995, at 97, 104–05 (describing the "green premium" for environmentally innovative firms).

⁶¹ E.g., NEIL GUNNINGHAM ET AL., *SHADES OF GREEN: BUSINESS, REGULATION, AND ENVIRONMENT* 20–40 (2003); Lesley Wexler, *Regulating Resource Curses: Institutional Design and Evolution of the Blood Diamond Regime*, 31 CARDOZO L. REV. 1717, 1742–65 (2010).

set” its carbon emissions, there is relatively little complexity in enforcing those promises.⁶²

Although more abstract promises, such as pledges to be “green,” shade closer to the challenges of contracting for charitable goods, international standards have developed to allow for verification of common best practices, including in the “green” context.⁶³ Uniform technical standards allow for more “modular” production, allowing firms to contract with each other more readily while retaining confidence that they meet the standards promised to consumers.⁶⁴

Admittedly, there is a real possibility that firms could capture their auditor, and so the process of establishing credibly independent verification systems is a challenge.⁶⁵ Firms may have to pay a premium to compensate independent auditors for the costs of maintaining a clean reputation. Hiring PricewaterhouseCoopers or Ernst & Young is not necessarily cheap. As long as this cost is less than the premium the counterparty would demand for its cold glow, however, the auditing expense is worthwhile. Some monitors may also act out of altruism or ideological commitment, making verification more affordable for smaller firms.⁶⁶

Surprisingly, though, there are legal obstacles to the thaw. Some commentators suggest that corporate law sets at least a default rule barring firm managers from maximizing anything other than shareholder profit.⁶⁷ At first glance, this seems bizarre. Remedying cold glow almost certainly provides returns on investment:⁶⁸ though of course the in-

⁶² Admittedly, it can be difficult to calculate carbon burdens when accounting for the entire chain of production and distribution for all of the firm’s inputs.

⁶³ See, e.g., Dennis D. Hirsch, *Green Business and the Importance of Reflexive Law: What Michael Porter Didn’t Say*, 62 ADMIN. L. REV. 1063, 1097–1105 (2010) (discussing the challenges of green monitoring in large firms); *Green Globe Certification Standard*, GREEN GLOBE, <http://greenglobe.com/green-globe-certification-standard/> (last visited Oct. 28, 2013) (providing a certification and ranking of the businesses that comply with the best “green” practices).

⁶⁴ Gereffi et al., *supra* note 57, at 85–88, 97.

⁶⁵ See Gabriele Jahn et al., *The Reliability of Certification: Quality Labels as a Consumer Policy Tool*, 28 J. CONSUMER POL’Y 53, 54–57 (2005).

⁶⁶ Timothy J. Feddersen & Thomas W. Gilligan, *Saints and Markets: Activists and the Supply of Credence Goods*, 10 J. ECON. & MGMT. STRATEGY 149, 151 (2001).

⁶⁷ For helpful critical commentary, see Lisa M. Fairfax, *Doing Well While Doing Good: Reassessing the Scope of Directors’ Fiduciary Obligations in For-Profit Corporations with Non-Shareholder Beneficiaries*, 59 WASH. & LEE L. REV. 409, 430–63 (2002); A.A. Berle, Jr., *For Whom Corporate Managers Are Trustees: A Note*, 45 HARV. L. REV. 1365, 1367–69 (1932).

⁶⁸ Janet E. Kerr, *Sustainability Meets Profitability: The Convenient Truth of How the Business Judgment Rule Protects a Board’s Decision to Engage in Social Entrepreneurship*, 29 CARDOZO L.

vestment might not pay off, courts generally treat managers' investment decisions with great deference.⁶⁹ Even if any positive returns are only for the managers, they still may well save the shareholders on the premium they would otherwise pay the manager to overcome her distaste.⁷⁰ Shareholders who don't experience the cold glow, and prefer the higher cash return, can simply sell and seek out another firm as evil as the warming firm used to be.⁷¹

One case most of these commentators point to, however, the 2010 Delaware Court of Chancery decision in *eBay Domestic Holdings v. Newmark*, makes a good bit more sense.⁷² The case involved a suit by a minority corporate shareholder of the online listings service "Craigslist." The majority stake was held by Craigslist's founders, who apparently saw their newspaper-killing enterprise as a public service, and who therefore refused to maximize revenues.⁷³ In this situation, the shareholder's argument was much stronger. Minority stakes in firms whose controlling interest is held by a founder with idiosyncratic views are, shall we say, not typically very liquid.⁷⁴ With the exit option off the table, one

REV. 623, 664–65 (2007); Judd F. Sneirson, *Green Is Good: Sustainability, Profitability, and a New Paradigm for Corporate Governance*, 94 IOWA L. REV. 987, 1009–10 (2009).

⁶⁹ Einer Elhauge, *Sacrificing Corporate Profits in the Public Interest*, 80 N.Y.U. L. REV. 733, 763–813 (2005).

⁷⁰ Perhaps the assumption is that the manager, unless constrained by law, will be relatively indifferent to the costs of remedying her distaste. In that case, the shareholders may lose significantly more than they would save in salary. Cf. *id.* at 836 (noting that managerial control of corporate charitable donations creates an additional way for a manager to extract rents).

An alternative justification for allowing managers to deviate from pure profit is that the goal of the firm is not simply shareholder value maximization, but instead maximizing the joint value for all of its stakeholders. Margaret M. Blair, *Corporate Law and the Team Production Problem*, in RESEARCH HANDBOOK ON THE ECONOMICS OF CORPORATE LAW, *supra* note 28, at 33, 47.

⁷¹ See Elhauge, *supra* note 69, at 808 (arguing that capital markets will discipline managers who deviate too far from shareholder preferences). Tax differences might also motivate a split between shareholders and the entrepreneur. Both can substitute warm glow for cash or vice versa. As we know, only the cash is taxed. If shareholders pay a lower rate of tax, they are less interested in replacing cash with emotional satisfaction. At present, U.S. taxes on dividends and profits from the sale of stock are taxed at about half of the rate of salary. See I.R.C. §§ 1(a)–(d), 1(h)(1), 1(h)(11), 1221 (2006).

⁷² 16 A.3d 1, 6 (Del. Ch. 2010); see J. Haskell Murray, *Choose Your Own Master: Social Enterprise, Certifications, and Benefit Corporation Statutes*, 2 AM. U. BUS. L. REV. 1, 13 (2012) (noting that defenders of social enterprise cite the *eBay* case "ad nauseam").

⁷³ *eBay*, 16 A.3d at 6, 8, 26.

⁷⁴ Craigslist also adopted provisions making it more difficult for eBay to sell. *Id.* at 35. An additional complication for eBay was that its stake, while a minority, was relatively large, so that selling it all at once would likely have significantly depressed the price per share. See *id.* at 44.

can at least see why the court would be more sympathetic to the “oppressed” minority shareholder—a shareholder which, as a firm, likely did not get any direct value from the warm glow-generating business model.

Our warmth-seeking entrepreneur now faces a catch-22. If she keeps a majority stake in her firm, she sets up a situation in which shareholders might take control of the firm in court.⁷⁵ On the other hand, of course, if she retains only a minority interest, the shareholders might take control in the boardroom. Either way, shareholders who prefer the chill—for example, because the opportunity for profit has increased or their tax on it has fallen—can force the entrepreneur to give up on her plans.⁷⁶ At that stage, the entrepreneur’s exit is problematic. She can sell her stake to the other shareholders, but by assumption she values cash less than the other aspects of the business. As a result, she may be unable to recover a good portion of the human capital she invested.

Presumably this is where the hybrid entity would step in. The entrepreneur offers investments in a firm that limits shareholders’ exit rights, or limits their ability to take control of the firm. The firm pledges to pursue only relatively more easily contracted for warm glow projects, such as selling only “conflict-free” diamonds.⁷⁷ Buyers take a lower cash return in exchange for higher warm glow. Since the shareholders’ protections against managerial profiteering are now more limited, they will likely want some guarantee that the entrepreneur won’t exit and leave the firm in control of a newer, cash-motivated manager.

Except that, as Brakman Reiser and Dean carefully show, existing social enterprise statutes don’t actually do those things.⁷⁸ Neither inves-

⁷⁵ I don’t want to overstate the significance of these legal impediments. See *Shlensky v. Wrigley*, 237 N.E.2d 776, 780 (Ill. App. Ct. 1968) (rejecting the argument that protection for minority interests should weaken the business judgment rule). My point is only that the argument for protecting minority shareholders is stronger when their ability to exit is lessened.

⁷⁶ See Katz & Page, *supra* note 24, at 96–97 (noting that social enterprise firms must guard against opportunistic conversion to profit-seeking by some stakeholders).

⁷⁷ Cf. Hansmann, *supra* note 9, at 887–88 (noting that federally subsidized affordable housing is sometimes built by “limited dividend” firms, and this is workable because the government can obtain detailed financial reporting on the firm relatively easily). I actually believe that Hansmann is wrong about the low costs of contracting for affordable housing, as contracting for the government’s goals in affordable housing is more difficult than he suggests. See Nestor M. Davidson, *Relational Contracts in the Privatization of Social Welfare: The Case of Housing*, 24 YALE L. & POL’Y REV. 263, 287–97 (2006) (describing the complex nature of public-private housing policy). But the general point remains that some goods can easily be contracted for and monitored.

⁷⁸ Brakman Reiser & Dean, *supra* note 2, at 1507–13.

tors nor entrepreneurs face a truly limited exit because all of the existing firms can readily be converted into a standard corporation, which can then be sold.⁷⁹ The added step may increase the costs of exit somewhat, but determined stakeholders on either side can still get out of the deal.

IV. IF SOCIAL ENTERPRISE STATUTES DO NOT ACCOMPLISH MUCH, WHY DO STATES KEEP PASSING THEM?

My theory predicts that the world should not have produced many hybrid firms, at least not under the set of rules currently available for them. No one has yet collected any good data on how much capital is invested in social enterprise organizations.⁸⁰ One available data point, however, is that a large and growing number of states have enacted statutes authorizing them.⁸¹ This seems an inconvenient fact for my theory.

It turns out, though, that the widespread legislative popularity of social enterprise has little to do with its merits. Social enterprise is the product of a race to the bottom. Perhaps that is too strong a term. It is, at a minimum, a device by which state governments are seeking to divert money from the federal treasury to the bank accounts of in-state firms.

Early proponents of hybrid entities were perfectly upfront about the tax motive. As they explained, the hope was that social enterprise organizations would be ruled eligible for “program-related investments” by nonprofit foundations.⁸² New York’s legislature even reported in its official explanation of one social enterprise bill that “[t]he

⁷⁹ *Id.*

⁸⁰ A preliminary tally of social enterprise organizations found that there are about 1000 firms nationwide, of uncertain size. See Ben Schreckinger, *Virtue Inc.: Can the New “Benefit Corporation” Charters Give Companies a Conscience?*, BOS. GLOBE, Nov. 25, 2012, <http://www.bostonglobe.com/ideas/2012/11/25/virtue-inc/sMNHJRcOIgZ0rqjpLTALrN/story.html>; *Here’s the Latest L3C Tally as of: September 27, 2013*, INTERSECTOR PARTNERS, L3C (Sept. 27, 2013), http://www.intersectorl3c.com/l3c_tally.html. Hybrid supporters also like to cite the example of the Grameen Bank, the well-known “micro-credit” organization. E.g., J. Haskell Murray & Edward I. Hwang, *Purpose with Profit: Governance, Enforcement, Capital-Raising and Capital-Locking in Low-Profit Limited Liability Companies*, 66 U. MIAMI L. REV. 1, 2–3 (2011). The Grameen Bank, though, is not a hybrid, and not even a corporation; it is a borrower-owned cooperative. *Grameen Bank at a Glance*, GRAMEEN BANK, http://www.grameen-info.org/index.php?option=com_content&task=view&id=26&Itemid=175 (last visited Sept. 27, 2013). The closest U.S. analogues to the Grameen Bank are member-owned mutual banks.

⁸¹ Brakman Reiser & Dean, *supra* note 2, at 1507–13.

⁸² John Tyler, *Negating the Legal Problem of Having “Two Masters”: A Framework for L3C Fiduciary Duties and Accountability*, 35 Vt. L. REV. 117, 122 (2010); Bruce D. Collins, *Low-Profits*, INSIDE COUNSEL (Jan. 2, 2008), <http://www.insidecounsel.com/2008/01/02/lowprofits>.

business entity form and legislation were drafted with the goal of complying with federal Internal Revenue Service (IRS) regulations relevant to Program Related Investments (PRIs) by foundations.”⁸³ The details are boring for most readers, but the gist is that federal tax law obliges foundations to spend 5% or so of their assets each year, with a narrow exception for investments that themselves could be described as accomplishing a charitable purpose.⁸⁴

If hybrids could qualify under the program-related investment exception, they could reap a federal tax bonanza of up to 20% or more of the costs of their capital. Assume that the marginal investor in the hybrid entity is a charitable foundation, a tax-exempt entity. Any profits paid by the hybrid to the foundation would be free of federal tax.⁸⁵ Presumably, the hybrid could pay a correspondingly lower rate of return. For instance, if a tax-paying investor would demand a 10% rate of return, but pays 20% in capital gains taxes, the investor nets 8% after tax. All else equal, a tax-exempt investor should accept that same 8% return.⁸⁶ The hybrid saves money, and the federal government collects less tax. Just as tax-exempt bonds are effectively a federal subsidy for state borrowers,⁸⁷ Program Related Investments status would be a federal subsidy for hybrids.⁸⁸

Now consider the political economy of a statute at the state level that authorizes hybrid entities. If a state legislator authorizes such hybrids, most of the federal costs of any subsidy that her state’s businesses receive will be paid for by taxpayers in the other forty-nine states. The hybrid’s investors may well be out of state, so the authorizing state

⁸³ S.B. S3011-2011, 2011–2012 S. Reg. Sess., (N.Y. 2011).

⁸⁴ Culley & Horwitz, *supra* note 1, at 8–11.

⁸⁵ This tax benefit would only be realized assuming that these payments are not subject to unrelated business income tax, which they likely would not be unless the underlying investments were purchased on margin. Cassady V. (“Cass”) Brewer, *A Novel Approach to Using LLCs for Quasi-Charitable Endeavors (A/K/A “Social Enterprise”)*, 38 WM. MITCHELL L. REV. 678, 705–07 (2012).

⁸⁶ Of course, the tax-exempt investor would rather earn 10%. But presumably there is enough value to the foundation in escaping the 5% payout requirement that it will accept a lower rate. See Brewer, *supra* note 85, at 712–13 (outlining the advantages of Program Related Investments over simple grant).

⁸⁷ See John M. R. Chalmers, *Default Risk Cannot Explain the Muni Puzzle: Evidence from Municipal Bonds That Are Secured by U.S. Treasury Obligations*, 22 REV. FIN. STUD. 281, 284–88 (1998).

⁸⁸ See Henry B. Hansmann, *Unfair Competition and the Unrelated Business Income Tax*, 75 VA. L. REV. 605, 612 (1989) (noting that “any business currently subject to the corporate income tax would yield a higher return in the hands of an exempt nonprofit than it does to its current shareholders because the corporate-level tax would be eliminated by such a transfer”).

doesn't even lose tax revenues on the investor's profits. What's not to like? And proponents are angling for other, more direct, federal incentives.⁸⁹

Imagine, too, that a neighboring state authorizes hybrids. If I am a North Carolina legislator, and in South Carolina, the businesses that employ my constituents can get a 20% federal subsidy, I can watch those jobs go across the border, or instead enact legislation that is virtually costless to me. Again, this is not a tough decision.

That's why I describe social enterprise statutes as a race to the bottom. Perhaps that's unfair; maybe there are good corporate governance justifications for the existing hybrid forms I've overlooked.⁹⁰ Given my alternative explanation, though, the simple fact that they have been popular with legislators does little to establish their efficiency.

V. HYBRID INSTRUMENTS, NOT HYBRID FIRMS?

To summarize the argument so far: existing social enterprise statutes give us solutions in search of a problem, while the real problem of exit in cold glow firms remains unsolved. This seems an opportune moment to return to Brakman Reiser and Dean. Their proposal, recall, is that firms should issue convertible debt securities, with a covenant permitting debt holders to assume a controlling equity interest if the entrepreneur attempts to sell before the end of a contractual period.⁹¹ In this way, they argue, both investors and entrepreneurs have assurances that the other party won't transfer control to purely profit-motivated buyers.⁹²

Though "FLYPaper" has its limits, on balance it seems like a promising solution for what I've called the cold glow firm. First, about some of those limits. As the duo acknowledges, entrepreneurs can effectively sell the firm without actually signing on a dotted line.⁹³ For instance, a founder could cause the firm to issue high-interest, subordinated debt, and use the proceeds to issue herself dividends. The new lender is basically an equity holder, and the founder has in essence cashed out her interest in the firm. More prosaically, the entrepreneur could just begin

⁸⁹ Strom, *supra* note 1 (describing the "quiet push to get preferential tax treatment for [hybrids]").

⁹⁰ Or maybe it is a race to the top—these entities could deserve more subsidies than society is currently giving them. *But see* Mayer & Ganahl, *supra* note 43, at 38–52. I am skeptical of this proposition, but will leave extended discussion on this topic for elsewhere.

⁹¹ Brakman Reiser & Dean, *supra* note 2, at 1498–99.

⁹² *Id.*

⁹³ *Id.* at 1522–23.

to manage the firm in a way that maximizes the cash value of her residual claim, elevating profit over other goals.

Brakman Reiser and Dean have an answer to these issues, but their answer only really works for the cold glow firm. They propose (in a footnote) that the equity conversion privilege could be triggered by events other than sale, such as if the manager extracts excessive dividends.⁹⁴ In other words, the parties negotiate contractual terms to prevent the manager from reneging on their deal. As we've seen, though, those contracts are typically prohibitively difficult to write when the firm is producing some complex charitable good.⁹⁵ They're reasonably manageable, however, for simple, cold-glow-reducing tasks.

Even aside from the possibility that the manager will renege on the nonprofit side of the deal, debt financing introduces additional agency costs for the firm. Nonprofits, too, can borrow.⁹⁶ Thus, if the entrepreneur has chosen a for-profit form, rather than a traditional nonprofit, she is signaling to creditors her willingness to manage the firm in a way that produces returns greater than a salary and pension could provide. Traditionally, this requires risk, which again is contrary to the preferences of most creditors.⁹⁷

In order to limit the resulting agency costs of borrowing, firms usually prefer a mix of debt and equity financing.⁹⁸ To get a sense of whether those costs are important, note that many firms continue to rely heavily on equity financing, despite a combined federal and state tax subsidy for borrowing that can range upwards of 40%.⁹⁹

Overall, though, the FLY paper proposal helps to fill the most important hole in social enterprise statutes. Convertible debt instruments are likely to be fairly ineffective at governing the daily business of an

⁹⁴ *Id.* at 1524 n.144.

⁹⁵ As Brakman Reiser & Dean note, contractual terms or "covenants" are common in the bond industry, *id.* at 1517 n.112, and this would be a standard way to prevent managers from issuing large amounts of new debt. But I am not aware of any existing covenant guaranteeing that managers will act charitably in other respects.

⁹⁶ For example, using data derived from the Form 990 tax returns filed annually by 501(c)(3) organizations, I calculated that the mean reported debt to asset ratio at reporting public charities during the 2009 fiscal year was about 44:1. Mean total debt was about \$59.5 million. I am grateful to the National Center on Charitable Statistics for providing me access to the 990 information.

⁹⁷ Jensen & Meckling, *supra* note 11, at 334–35.

⁹⁸ For a basic overview of the considerations involved in the balance between debt and equity, see CARNEY, *supra* note 25, at 217–29.

⁹⁹ For a review of the importance of the tax distortion in debt-equity decisions, see Ruud A. de Mooij, *The Tax Elasticity of Corporate Debt: A Synthesis of Size and Variations* 22–23 (Int'l Monetary Fund, Working Paper No. 11/95, 2011), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1826548.

entity conducting both profitable and complex charitable activities. Then again, combining those two forms will rarely be feasible under any governance structure. FLY paper really takes off when issued by firms wanting to commit to relatively simple, discrete tasks; in that setting it both provides protection against opportunistic exit and also may help with daily governance.

CONCLUSION

Brakman Reiser and Dean propose a welcome addition to the existing corporate governance toolkit. Although the specific instrument they describe has some limitations, their idea also opens a promising avenue for further innovation.¹⁰⁰ As I mentioned earlier, the absence of effective pay instruments for aligning managerial and stakeholder interests adds greatly to the costs of contracting for the production of charitable goods. If future generations of FLY Paper-like instruments—FLY spawn?—could fill that gap, they would revolutionize the charitable firm.¹⁰¹

In the meantime, their work adds an appropriate note of caution to recent social enterprise exuberance. I have tried to deepen that note here. So far, social enterprise looks more like a state scheme for extracting federal subsidies than a solution for any corporate governance problem.

¹⁰⁰ For example, states could experiment with alternative formulations of default rules for hybrid instruments. Investors could diversify the risk of each alternative scheme by putting money in firms in each of the rival jurisdictions. Cf. Kelli A. Alces, *Legal Diversification*, 113 COLUM. L. REV. 1977 (suggesting that legal rules may supply a source of diversification).

¹⁰¹ For another set of possibilities, see Julia Y. Lee, *Gaining Assurances*, 2012 WIS. L. REV. 1137, 1145–59 (describing the use of conditional guarantees to overcome problems of collective contribution to shared goods).

